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No. 663

Supreme Court of the United States

(October Term, 1951)

N. T. Sharp,
Petitioner,

VERSUS

H. C. Jones, Collector of Internal Revenue,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT, AND SUPPORTING BRIEF

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March, 1952.

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No. 683

In the
Supreme Court of the United States
(OCTOBER TERM, 1951)

N. T. SMITH,
Petitioner,

VERSUS

H. C. JONES, Collector of Internal Revenue,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT, AND SUPPORTING BRIEF

PETITION FOR WRIT OF CERTIORARI

To the Honorable the Justices of the Supreme Court of the United States:

The above named petitioner respectfully shows:

I.

SUMMARY STATEMENT OF THE MATTER INVOLVED

This action was brought in the United States District Court for the Western District of Oklahoma, by petitioner, against H. C. Jones, Collector of Internal Revenue, under

the provisions of the Internal Revenue Code, for recovery of income tax and interest thereon, alleged to have been erroneously collected by H. C. Jones, Collector of Internal Revenue for the District of Oklahoma. The petitioner will sometimes be referred to herein as plaintiff or taxpayer or by name.

The petition alleged that the Collector of Internal Revenue had erroneously denied a deduction of a loss suffered by the Smith Brothers Drilling Company, a partnership, thereby overstating the plaintiff's distributable share and overstating the plaintiff's net income $9,554.73. This was denied in the defendant's answer.

At the trial, the taxpayer assumed the burden of proof cast upon him under the issues, and introduced evidence to support his petition. The defendant, the Collector, introduced none. On the uncontradicted testimony of the plaintiff, the trial court found that the partnership suffered the loss in 1944, and that the loss was properly reported by the plaintiff in 1944, and held for the plaintiff.

The trial court made appropriate findings of fact upon which its judgment was based. The defendant did not except to the trial court's findings or ask for findings on any issue.

The defendant did not urge that the findings of the trial court were against the weight of the evidence in the United States Court of Appeals.

The United States Court of Appeals reversed the judgment. In reversing the judgment, the Appellate Court

did not find that the findings made by the trial court were against the weight of the evidence. The Court just ignored the trial court's findings and made contrary findings based on facts not in the record and contrary to the uncontradicted evidence. The assumed facts were not testified to nor was the plaintiff afforded an opportunity to test their accuracy by cross-examination or rebuttal evidence. The assumed facts are contrary to the evidence and the findings of the trial court.

The judgment of the Court of Appeals that a loss must be deferred is contrary to the statute and regulations, and the judgments of other circuits and this Honorable Court.

II.

DECISION BELOW

The trial court's decision is reported in 94 Fed. Supp. 686. Its findings of fact and conclusions of law and judgment appear in the Record at pages 25 to 30. The decision of the Court of Appeals, Tenth Circuit, was filed December 21, 1951, and reported in 193 Fed. (2d) 381. Petition for Rehearing was denied January 30, 1952.

III.

JURISDICTION

The jurisdiction of the Court is invoked under Sec. 240(2) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938, 28 U. S. C. A., Sec. 347(2)

and/or Chapter 133, Sec. 2101(c), Title 28, United States Code, Judiciary and Judicial Procedure, approved June 25, 1948, effective September 1, 1948.

QUESTIONS PRESENTED

The following questions are presented:

(1) Whether the Court of Appeals can ignore the findings of fact of the trial court, which are supported by uncontradicted evidence, and make *contra* findings.

(2) Whether the Court of Appeals can make findings contrary to the record on facts not testified to and upon which the plaintiff was not afforded the opportunity to test their accuracy by cross-examination or rebuttal evidence.

(3) Whether a partnership, engaged in the oil well drilling business, who suffers a determinable loss in 1944, due to the abandonment or loss of a drilling well which resulted from a cave-in caused by outside physical force, an underground movement or disturbance, and which occurred suddenly and unexpectedly, can or must defer the loss to another year in determining its distributable net income under the Internal Revenue Code.

REASONS RELIED ON FOR ALLOWANCE OF THE WRIT

The following reasons are relied on for the allowance of the Writ:

First: The Court of Appeals has so far departed from the accepted and usual course of appellate procedure and jurisdiction as to require this Court's supervision.

(a) In making findings contrary to the findings of the trial court.

(b) In making findings not justified, contrary to the record, and upon facts which the plaintiff was not afforded the opportunity to disprove their accuracy by cross-examination or rebuttal testimony.

Second: The judgment of the Court of Appeals on a Federal question is in conflict with other circuits, and the decisions of this Court.

(a) In determining that a loss fixed by identifiable events, *bona fide* and actually sustained during the taxable period must be deferred to another period.

(b) In holding that a strained construction of accounting practice will supersede the positive provision of the statute and the regulation.

WHEREFORE, your petitioner prays that a Writ of Certiorari issue under the seal of this Court directed to the United States Court of Appeals, Tenth Circuit, at Denver, Colorado, commanding said Court to certify and send to this Court a full and complete transcript of the record and of the proceedings which said Court had in

Case No. 4289, entitled H. C. Jones, Collector of Internal Revenue, Appellant, v. N. T. Smith, Appellee, to the end that such cause may be reviewed and determined by this Court, as provided by its rules and the statutes of the United States, and that the judgment of said United States Court of Appeals in said cause be reversed by this Court, and for such further relief as to this Court may seem proper.

Dated at Oklahoma City, Oklahoma, this 17th day of March, 1952.

RAM MORRISON,
1816 Petroleum Building,
Oklahoma City, Oklahoma,
Attorney for Petitioner.

BRIEF IN SUPPORT OF PETITION

DECISION BELOW

The trial court's decision is reported in 94 Fed. Supp. 686. Its findings of fact and conclusions of law and judgment appear in the Record at pages 25 to 30. The decision of the Court of Appeals, Tenth Circuit, was filed December 21, 1951, and reported in 193 Fed. (2d) 381. Petition for Rehearing was denied January 30, 1952.

JURISDICTION

The jurisdiction of the Court is invoked under Sec. 240(2) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938, 28 U. S. C. A., Sec. 347(2) and/or Chapter 133, Sec. 2101(c), Title 28, United States Code, Judiciary and Judicial Procedure, approved June 25, 1948, effective September 1, 1948.

STATEMENT OF THE CASE

The petitioner is a member of a partnership, Smith Brothers Drilling Company, engaged in the oil well drilling business. The alleged over assessment complained of herein is due to an increase of the petitioner's distributable share of income from the partnership which caused an overstatement of his income for the year of 1944.

Smith Brothers Drilling Company performed contracts which are usually completed within 30, 60, or 90 days. In 1944, it entered into a contract to drill a well

to 4,500 feet for $22,500.00, and providing for day work after that depth was reached at so much per day, at the election of the contractee. The well was commenced on November 1, 1944, and on November 18, 1944, was drilling at 2,614 feet, the hole was within one degree of perpendicular, the mud 38 viscosity, no evidence of caving, was coming out of the hole the thirteenth time to change a bit, and the drill pipe was 960 feet off bottom when the drill pipe suddenly froze. A very unusual thing under the circumstances. The hole was abandoned on December 1, 1944, the cost of the hole and the fishing to free the pipe was $14,332.55 which was taken as a deduction against gross income in the year the hole was abandoned (Stip., R. 22-21-50).

The partnership used a method of keeping its books and reporting its distributable net income used in the oil industry (R. 51). Used a refined accrual method to more accurately state income (R. 51). Under the method, it followed the practice of charging direct cost of materials and labor in cutting the hole into a work in progress account, in the nature of an inventory account, and deferred them until the inventory was applied toward to completion of the contract, as which time it was charged into expense to offset the income to which it directly contributed (R. 51). In closing its books at the end of the period it carried this account, as an inventory, into the Profit and Loss Statement at cost or market, whichever is lower, just like any other inventory account (R. 37, 55).

The Commissioner determined (R. 17):

> "It has been determined that drilling done by the partnership should be reported on a completed con-

tract basis and therefore, a deduction of $14,332.55 that was claimed with respect to an oil and gas test known as the Blyth #1, a contract on which operations were started in 1944 and completed in 1945, should be denied."

In the pleadings the issue was joined on the correctness of this determination of the Commissioner which was the basis for the additional assessment. At the trial the petitioner introduced evidence to support his petition but the defendant introduced none. The defendant made no request for findings of fact and did not except to the findings made by the trial court. In its opinion at page 27 and 28 the trial court found:

"It is wholly immaterial whether the contract was the 'unit of operation', or the well was the 'unit of operation;' whether the books were kept on the 'completed contract basis' or otherwise. So far as the first hole drilled was concerned, when it was abandoned the transaction was complete, a closed incident, and the contract at an end so far as it pertained to the loss sustained.

"Under the stipulation and facts shown, there is no room for a strained or ingenious construction to be indulged in here. The facts are plain and undisputed. The transaction on the first well was complete and the undisputed loss sustained in the year 1944 and properly reported in the tax return for the year 1944.

"The court finds that the partnership used a bookkeeping method in keeping its accounts and reporting its distributable net income which is recognized, accepted and in common usage in the industry.

"The method of keeping the accounts and reporting distributable net income clearly and correctly reflects the distributable net income.

"Under the method of keeping the accounts and reporting the distributable net income, the loss is a proper deduction in determining the distributable net income of the partnership in 1944.

"The loss was sustained in the trade or business of the partnership."

The Court of Appeals found that the partnership used in a long-term contract method as defined under the Regulation 111, Section 29.42-4, commonly used by construction contractors on construction contracts covering a period in excess of one year, as distinguished from the well recognized and accepted refined accrual method used in the oil industry. The Court stated in its opinion:

"Instead, such a loss is an incident which may arise in the drilling of deep wells of that kind. And a loss sustained in that manner is not deductible under the statute and the regulation during the year in which it occurs if the books and records of the taxpayer are consistently kept and its information tax returns consistently filed on substantially the completed contract basis and the contract for the drilling of the particular well is not completed until the next year.

"In its books and records, the partnership maintained a separate account for each contract to drill a well. All direct costs incurred in the performance of that contract were debited to such account. At the end of the taxable year these tangible costs were deferred on uncompleted contracts and were not carried into the profit and loss account as earnings of the business until the contract to which they related was completed. General overhead expenses were deducted in the taxable year in which they were incurred (R. 96).

"It was substantially the long-term contract method as applied to completed contract basis. And under the system, the contract for the drilling of the well in question was the unit of operation in computing gain or loss arising from the performance or fulfillment of the contract (R. 98).

"And under the accounting practice of keeping the books and records of the partnership, such expenditures were to be taken into consideration in determining the profit or loss on the completion of the contract in 1945. Treating them as deductible in 1944 rather than in 1945 constituted a departure from the accounting practice of the partnership on which its information returns were prepared and submitted" (R. 99).

SPECIFICATIONS OF ERROR

I. The Court of Appeals erred in reversing the trial court and holding that the loss suffered by this partnership in 1944, due to the abandonment or loss of a drilling well, which resulted from a cave-in caused from outside physical force, an underground movement or disturbance, and which occurred suddenly and unexpectedly, can and must be deferred to another year in determining its distributable net income under the Internal Revenue Code.

II. The Court of Appeals erred when it made findings of fact contrary to the findings of the trial court on the bookkeeping method used by the partnership.

III. The Court of Appeals erred in making findings contrary to the record, upon facts which the appellant was not afforded the opportunity, by cross-examination or

rebuttal evidence, to disprove, and which were inferentially contrary to the findings and judgment of the trial court.

(a) In finding that, under the bookkeeping method used by the partnership, the contract was the unit of operation.

(b) In finding that under the bookkeeping method used by the partnership, all the direct costs of the contract were deferred to the completion of the contract before being taken into expense.

(c) In finding that income, after the Commissioner's adjustment, was substantially correct on a "completed contract basis."

SUMMARY ARGUMENT

Proposition I.

The Appellate Court erred when it held that a loss incurred by the partnership in 1944, due to the abandonment or loss of a drilling well (caused by a case-in) must be deferred to another tax period before it is a deduction against gross income under the Internal Revenue Code. The statute, Section 23, DEDUCTIONS AGAINST GROSS INCOME, provides that expenses and losses are permitted deductions against gross income. The Court of Appeals cannot call a loss under Section 23(e)(1) an expense under Section 23(a) in order to defer it from the year incurred to another tax year and thereby justify an erroneous assessment. The Court cannot deny a loss as a deduction or defer the loss contrary to the plain provision of the statute. The Court of Appeals erred in holding that a bookkeeping method and not the statute controlled the character of a deduction against gross income, and the year the loss was a deduction against gross income.

Proposition II.

The trial court, in its findings, found the bookkeeping method used by the partnership, and found, as a fact, when the loss was incurred. These findings were ignored by the Appellate Court. Contrary findings were made on these fact issues. The Circuit Court abandoned established procedure, and its jurisdiction, when it made these contrary findings.

Proposition III.

The Appellate Court, in making contrary findings to the findings of the trial court, assumed facts not in the record, or facts not a proper deduction upon any of said record facts, and inferentially contrary to the judgment of the trial court, and upon which the appellant was not afforded the opportunity to disprove by rebuttal evidence or through cross-examination.

ARGUMENT

Proposition I.

The Court of Appeals erred in reversing the trial court and holding that the loss suffered by this partnership in 1944, due to the abandonment or loss of a drilling well, which resulted from a cave-in caused from outside physical force, an underground movement or disturbance, and which occurred suddenly and unexpectedly, can and must be deferred to another year in determining its distributable net income under the Internal Revenue Code.

It is stipulated (R. 25):

"The partnership carried the cost of $14,332.55 into the partnership books as a loss and deducted it in determining the distributable net income of the part-

nership for the year 1944. The Commissioner disallowed the loss for the year 1944 and ruled that any loss sustained was deductible in determining the net income for the subsequent year, the year in which the work under the contract was completed."

The trial court found (R. 28):

"Under the stipulation and facts shown, there is no room for a strained or ingenious construction to be indulged in here. The facts are plain and undisputed. The transaction on the first well was complete and the undisputed loss sustained in the year 1944 and properly reported in the tax return for the year 1944."

In the special findings (R. 28):

"The loss was sustained in the trade or business of the partnership.

"Under the method of keeping the accounts and reporting the distributable net income, the loss is a proper deduction in determining the distributable net income of the partnership in 1944."

The Court of Appeals, in reversing the trial court, said (R. 99):

"Instead, such a loss is an incident which may arise in the drilling of deep wells of that kind. And a loss sustained in that manner is not deductible under the statute and regulation during the year in which it occurs if the books and records of the taxpayer are consistently kept and its information tax returns consistently filed on substantially the completed contract basis and the contract for the drilling of the particular well is not completed until the next year."

Under the Internal Revenue Code, Title 26, U. S. C. A.:

"SECTION 23, DEDUCTIONS FROM GROSS INCOME:

"In computing net income there shall be allowed as deductions:

"(a) Business Expense,

* * * * * * * *

"(e) Losses by Individuals—In the case of an individual, losses sustained during the taxable year and not compensated by insurance or otherwise—

"(1) if incurred in trade or business, or

* * * * * * * *

"(i) Basis of Determining Loss:—The basis of determining the amount for losses sustained, to be allowed under subsection (e) or (f), and for bad debts, to be allowed under subsection (k), shall be the adjusted basis provided in Section 113(b) for determining the loss from the sale or other disposition of property."

Under Section 113(b) Adjusted Basis, the loss is correctly determined at $14,332.55, the amount stipulated.

Treasury Regulation 111, promulgated under the Internal Revenue Code:

"Section 29.23(e)-1. Losses by Individuals—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, * * *

"In general losses for which an amount may be deducted from gross income must be evidenced by

> closed and completed transactions, fixed by identifiable events, *bona fide* and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses, * * *"

Under the specific findings of the trial court, and under Section 23(e)(1) of the Internal Revenue Code, a loss was incurred by the partnership, and it was a completed transaction when the hole was abandoned. Section 23(i) provides the basis for determining the loss. Under Section 113(b) the loss was correctly determined as $14,332.55, which amount was stipulated.

Under the statute and regulation both expenses and losses are permitted as deductions against gross income in determining the partnership's distributable net income. *Higgins* v. *Smith,* 60 Sup. Ct. 355, 308 U. S. 473, 84 L. Ed. 406, 410.

Income may not be withheld because losses may thereafter occur. *Heiner* v. *Mellon,* 58 Sup. Ct. 926, 304 U. S. 271, 82 L. Ed. 1337. Conversely, losses cannot be deferred to either make or prevent additional assessments or to reduce income. *Burnett* v. *Sanford & B. Company,* 282 U. S. 359, 75 L. Ed. 383, 51 Sup. Ct. 150.

The use of bookkeeping terms, accounting forms and devices cannot be permitted to devitalize valid tax laws. *Foster* v. *United States,* 303 U. S. 118, 121, 82 L. Ed. 700, 701, 58 Sup. Ct. 424; nor can the Court, on a bookkeeping theory, call a loss, under Title 26, U. S. C. A., Section 23(e)(1) and Regulation 111, Section 29.23(e)(1), expense under Section 23(a), and thereby defer a loss from the

year the loss was incurred. *United States* v. *White Dental Mfg. Co.*, 274 U. S. 398, 71 L. Ed. 1120, 1122, 47 Sup. Ct. 598. The mere fact that under Title 26, U. S. C. A., Section 23(i), Basis for Determining Loss, thereunder to be the same as is provided in Section 113(b) for determining gain or loss from the sale or other disposition of property, shows that the statute contemplates the deduction of this loss when it was incurred. *Dayton Company* v. *Comm.* (C. C., 8), 90 Fed. (2d) 767, 769; *Ferguson* v. *Comm.* (C. C., 10), 59 Fed. (2d) 893, 894.

Loss to the partnership, being conceded here, the question of the year in which a loss is sustained is one of fact. *Ashland Iron & Mining Co.* v. *United States*, 74 Ct. Cl. 172, 56 Fed. (2d) 466, 121 A. L. R. 702; *Dayton* v. *Comm.* (C. C., 8), 90 Fed. (2d) 767; *Hall* v. *Comm.* (C. C., 7), 128 Fed. (2d) 180, 182; *Superior Coal Co.* v. *Comm.* (C. C., 7), 145 Fed. (2d) 597, 599; *Belser* v. *Comm.* (C. C., 4), 174 Fed. (2d) 386; *Curtis* v. *Comm.* (C. C., 7), 183 Fed. (2d) 7, 10; *Curtis* v. *Helvering, C. I. R.* (C. C., 2), 110 Fed. (2d) 1014; *Comm. I. R. C.* v. *Peterman* (C. C., 9), 118 Fed. (2d) 973.

The trial court did not find or hold that regardless of the bookkeeping method employed by the partnership, the $14,332.55, as expense under the contract, should be taken as a deduction against gross income in 1944. The trial court found and held that under Section 23(e)(1) and Regulation 111, Section 29.23(e)(1), the partnership suffered a loss in 1944, and that under Sections 23(i) and 113(b), the loss was $14,332.55. That under the statutes and the regulation the loss was a deduction against gross income in 1944. That the fact that the adjusted basis of

the asset, under Sections 23(i) and 113(b), upon which the amount of the loss is determined, was a sum calculated upon the deferred expense, deferred under a bookkeeping method, does not change the character of the deduction from a loss under Section 23(e)(1) to an expense deduction under Section 23(a). The adjusted deferred expense, under the bookkeeping method, would be calculated by reducing it by the amount of the loss suffered. This would be so on any bookkeeping method. The trial court's holding and judgment is eminently correct. The Court of Appeals has committed grave error.

The Court of Appeals reversed the trial court and held that the bookkeeping method and not the statute controlled the character of the deduction and the year it was a deduction against gross income. In the Appellate Court's opinion, it admits there is a loss but says that a loss sustained in this manner is not deductible under the statute; that the loss contemplated under the statute is a loss suffered on the operation under a contract. That the loss under the contract could not be determined until the contract was completed. But the statute does not make "loss under the contract" a deduction against gross income. It is true that expense is a deduction and through deducting it the taxable income for the period is determined. The holding of the Appellate Court vitiates Section 23(e)(1) and makes Section 23(a) the only deduction available to the partnership under the statute.

This holding of the Court of Appeals is contrary to the statute, Title 26, U. S. C. A., Section 23, Deductions Against Gross Income, and in conflict with the holdings

of this Honorable Court in *United States* v. *White Dental Mfg. Company, supra; Foster* v. *United States, supra; Dayton* v. *Comm.* (C. C., 8), *supra; Rhodes* v. *Comm.* (C. C., 6), 100 Fed. (2d) 966; *Comm. I. R. C.* v. *Peterman* (C. C., 9), *supra; Bartlett et ux* v. *Comm.* (C. C., 4), 114 Fed. (2d) 634; *Industrial Rayon Corp.* v. *Comm.* (C. C., 6), 94 Fed. (2d) 383.

Proposition II.

The United States Court of Appeals erred when it made a finding of fact contrary to the finding of fact of the trial court on the bookkeeping method used by the partnership.

The trial court found that the partnership used a bookkeeping method which was used in the industry, which was well defined in the evidence. The Court of Appeals found that the partnership used a bookkeeping method commonly used by building contractors and as defined in the Regulation 111, Section 29.42-4.

The bookkeeping method used by the partnership is a question of fact. *United States* v. *Anderson,* 269 U. S. 422, 46 Sup. Ct. 131, 70 L. Ed. 347; *Niles Bement Pond* v. *United States,* 281 U. S. 357, 50 Sup. Ct. 251, 74 L. Ed. 901; *United States* v. *American Can Co.,* 280 U. S. 412, 50 Sup. Ct. 177, 74 L. Ed. 518.

The Court of Appeals, as an Appellate Court, cannot make contrary findings. *Wilmington Trust Co.* v. *Helvering,* 62 Sup. Ct. 984, 316 U. S. 164, 86 L. Ed. 1352; *General Utilities & Operating Co.* v. *Helvering,* 56 Sup. Ct. 185, 296 U. S. 200, 80 L. Ed. 154; *Helvering* v. *Rankin,* 55 Sup. Ct. 732, 295 U. S. 123, 79 L. Ed. 1343. The Tenth Circuit in

other cases has recognized the court's limitation. *Anderson* v. *Commissioner*, 81 Fed. (2d) 457.

It is a serious departure from established procedure for an Appellate Court to make contrary finding to the trial court and especially when it is also against the clear undisputed evidence, as here, and warrants this Honorable Court's supervision. With the increase of litigation between the Government and the citizen, it becomes increasingly important that this Honorable Court be zealous in its protection of the right of a citizen, and assure to the citizen a fair trial under the established procedure.

Proposition III.

The United States Court of Appeals erred in making findings contrary to the record, upon facts which the appellant was not afforded the opportunity, by cross-examination or rebuttal evidence, to disprove. Said finding is inferentially contrary to the findings and judgment of the trial court.

(a) In finding that, under the bookkeeping method used by the partnership, the contract was the unit of operation.

(b) In finding that under the bookkeeping method used by the partnership, all of the direct costs of the contract were deferred to the completion of the contract before being taken into expense.

(c) In finding that income, after the adjustment, was substantially correct on a "completed contract basis."

STATEMENT

Under the evidence, there are two acceptable bookkeeping methods, used in the oil industry, one a strict accrual method and the other a refined accrual method

which is used by the partnership (R. 51). Under the refined accrual method used by the partnership, the direct cost of labor and materials in cutting the hole is carried into an inventory account. At the end of the accounting period, this account is valued at cost or market, whichever is lower, and deferred until the well is completed. It is then charged against the income to which it directly contributes. The excess over the economic value of the hole, at the close of the tax period, is charged into expense in closing the books and determining the distributable net income for the closing tax period (R. 37, 50-61).

(a) In finding that, under the bookkeeping method used by the partnership, the contract was the unit of operation.

On this record, and inferentially contrary to the findings and judgment of the trial court, the Court of Appeals found that "the contract was the unit of operation." No one testified to a state of facts upon which the Court of Appeals is justified in making such a finding. On the other erroneous finding (quoted below), made by the Appellate Court, such a finding or deduction is not warranted since, under said finding, all of the expense of performing the contract is, admittedly, not deferred. *Gray Harbour Motorship Corporation* v. *United States* (Ct. Cl.), 45 Fed. (2d) 259.

(b) In finding that under the bookkeeping method used by the partnership, all of the direct costs of the contract were deferred to the completion of the contract before being taken into expense.

The Appellate Court found:

> "All direct costs incurred in the performance of the contract were debited to such account. At the end of the taxable year these tangible costs were deferred on uncompleted contracts and were not carried into the profit & loss account as earnings of the business until the contract to which they related was completed. General overhead expenses were deducted in the taxable year in which they were incurred."

If the Appellate Court, when it said "all direct costs incurred in the performance of the contract" meant that "the direct cost of labor and materials in cutting the hole", and if when the Court said "these tangible costs were deferred" it meant that "these costs or the economic value of the hole at the close of the accounting period, whichever is lower, is deferred to the completion of a contract that extends into another tax period" the findings would follow the evidence, the trial court's findings and judgment. The Circuit Court did not follow the record when it held that the partnership was on a "completed contract basis" as defined under the Regulation 111, Section 29.42-4.

(c) In finding that income, after the adjustment, was substantially correct on a "completed contract basis."

The Circuit Court held that the partnership's books were "substantially correct on a completed contract basis." "Substantially" is a comparative term. Since no witness testified to a set of facts upon which this deduction could be made, or to the fact that the books were on the completed contract basis, as defined under the regulation, the petitioner was denied the opportunity, by cross-examination or rebuttal testimony, to show the facts upon which the accuracy of the Circuit Court's finding of "substantially correct" could be determined.

In order to determine how accurate the partnership's books are on the "completed contract basis", under the regulation, the amount of the expenses deferred as compared with all the expenses of the contract, as well as the other differences in method, should have been before the Court. Since no witness, not even the Commissioner, testified or said the partnership's books were on the completed contract method under the regulation, the petitioner could not speculate and disprove something not yet directly in issue. The Circuit Court's deduction is mere speculation, made without reasonable opportunity afforded the petitioner, under regular judicial processes, to defend, and contrary to the evidence.

It might be observed that in the opening statement made by counsel for the Government, he stated:

> "Each year that they filed their partnership return they reported the drilling contracts on what may be termed a completed contract basis. In other words,

a well which was started in 1941 but completed in 1942 was accounted for in the year 1942 when it was completed. All of the expenses which occurred in 1941 in connection with the drilling of that well were charged in the tax year of 1942 when they received the money for completing the well."

After this statement, counsel was asked:

"Mr. Morrison: I would like to ask counsel for the government a question. He used the term 'Completed contract'. I would like to ask him if he refers to a completed contract under Regulation 111, Section 29, point 42-4, if that is what he means by completed contract?

Mr. Pester: When I speak of a completed contract I speak in general terms any ordinary man would understand without regard to the regulations or statute.

Mr. Morrison: That doesn't answer my question."

The question went unanswered. However hesitant counsel was to state the Government's position in the trial is made up in the Appellate Court after the record is closed to the petitioner. There was no evidence to support the opening statement in which the Government contended that all the expense of the contract was deferred to the completion of the contract. This statement is also contrary to the finding made by the Appellate Court.

The partnership did nothing required of it under the regulation to report its income on the "completed contract" basis. If it had asked the Commissioner, it was his duty under the statute to have refused permission. Robert M. Robinson, 41406 Memo., B. T. A. Docket No.

106,037, Aug. 30, 1941. All the costs of the contract would have to be deferred under the method (Regulation 111, Section 29.42-4). *Gray Harbour Motorship Corporation* v. *United States, supra.* This the Commissioner did not require nor did the Appellate Court in its judgment. The Appellate Court found that the income was substantially correct on the basis it and the Commissioner put the partnership's books but the trial court found that income was correct on the method used by the partnership before the adjustment. The result of the Appellate Court's judgment is to change the partnership's distributable net income from accurate on the method used by the partnership, to substantially accurate on the completed contract method under the regulation.

It is not the province of the Court to weigh and determine relative merits of systems of accounting which taxpayer may employ. *Brown* v. *Helvering,* 54 Sup. Ct. 356, 291 U. S. 192, 78 L. Ed. 725. If the method used clearly reflects income, the statute is mandatory; the Commissioner must respect that method of accounting. So does the Court. *Huntington Securities Corporation* v. *Bussy,* 112 Fed. (2d) 368; *M. D. Rowe,* 7 B. T. A. 903.

CONCLUSION

It would seem that the good faith of the taxpayer, his diligence in employing competent help to assist him in the keeping of his accounts and preparing his return, the fact that the loss was reported correctly under the universal practise in the industry, the plain letter of the

statute, and the findings of fact and judgment of the trial court, were not of passing consideration in the Court of Appeals and therefore this taxpayer is without alternative and must apply to this Honorable Court for protection against an arbitrary assessment and judgment.

Respectfully submitted,

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March, 1952.

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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 683

N. T. SMITH, *Petitioner*

v.

H. C. JONES, COLLECTOR OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to The United States Court of Appeals for the Tenth Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 25-28) is reported at 94 Supp. 686. The opinion of the Court of Appeals (R. 95-100) is reported at 193 F. 2d 381.

JURISDICTION

The judgment of the Court of Appeals was entered on December 21, 1951. (R. 100.) The taxpayer's petition for rehearing, filed on January

23, 1952 (R. 100-101), was denied on January 30, 1952 (R. 101). The petition for a writ of certiorari was filed on April 2, 1952. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether, in the light of its regularly employed accounting practices, Smith Brothers Drilling Company, a partnership, may deduct in 1944 the cost incurred in that year of drilling an oil well which caved in during 1944, and before the depth required by the drilling contract was reached, where full performance of the drilling contract was not completed until 1945.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Treasury Regulations are set forth in the Appendix, *infra,* pp. 11-13.

STATEMENT

The pertinent facts stipulated and found by the District Court are as follows:

On October 10, 1944, Smith Brothers Drilling Company, a partnership in which taxpayer was a partner, entered into a contract with one C. L. Carlock in which the partnership agreed to drill an oil well in Garvin County, Oklahoma. The contract provided that the well should be drilled to a depth of 4,500 feet, or to the Bromide Sand, and if such sand was encountered, the well should

be drilled 50 feet in the sand. The drilling of the well was to commence on or before November 1, 1944, to be conducted with due diligence, and to be completed within a period of six months from the date of the contract. (R. 25-26.) The drilling operation was to be at the cost, risk and expense of the drilling company. (R. 27.)

On or about November 1, 1944, the well was commenced and on November 18, 1944, had been drilled to a depth of 2,614 feet. On that date, a cave-in of the hole occurred and it was abandoned. The rig was skidded to a new location and, on December 1, 1944, another hole was begun. The drilling to the 4,500 feet depth under the terms of the contract was completed on January 23, 1945. Under an amendment to the contract, ten days additional work was completed on February 2, 1945. Under a second amendment to the contract, seven days additional work was completed on February 9, 1945, and the drilling was continued for several days thereafter under an oral agreement. (R. 26.)

The cost of $14,332.55, expended in drilling the hole which was abandoned, was carried into the partnership books as a loss and deducted in determining the distributable net income for 1944. The Commissioner of Internal Revenue disallowed the deduction for 1944 and ruled that it was deductible in 1945, the year in which the contract was completed. (R. 26.) Taxpayer paid a deficiency as-

sessment and interest in the sum of $8,700.27 (R. 26); filed a timely claim for refund (R. 23); and, after it was disallowed (R. 20), filed the present suit for refund in the District Court.

Additional facts as brought forth by uncontradicted testimony and exhibits are as follows:

The drilling of a well usually required from 30 to 90 days and sometimes four months. (R. 72.)

In its books and records, the partnership maintained a separate account for each contract to drill a well. All direct costs incurred in the performance of that contract were debited to such account. At the end of the taxable year, these tangible costs were deferred on uncompleted contracts and were deducted in computing the net gain or loss upon such contracts at the time each was completed. General overhead expenses were deducted in the taxable year in which they were incurred. (R. 51, 54.) The partnership established and maintained that accounting practice preceding and following the execution and fulfillment of the contract with Carlock. And the partnership regularly filed information tax returns in which direct costs allocable to each contract were treated in that manner. (R. 54, 75, 89.)

The deduction of the direct expenses incurred in connection with the caved in well was the only instance in which tangible costs under the drilling contracts were deducted in a year other than the year in which the contract was completed. (R. 54, 75, 89.)

The District Court held that the loss was sustained in the trade or business of the partnership and that the transaction on the caved-in hole was complete in 1944. It concluded that the undisputed loss was sustained in the year 1944, and properly reported in the tax return for that year. (R. 28.) The Court of Appeals reversed the District Court and held that since the partnership kept its books and filed its information returns on "substantially the completed contract basis," the deduction could not be taken until 1945, the year in which the contract was completed. (R. 100.)

ARGUMENT

This controvery arises not over a question of deductibility but simply as to the year the deduction is to be taken. The taxpayer seeks to deduct his allocable share of a partnership's expenses attributable to the collapse of a well being dug under contract in 1944, the year in which the cave-in of the well occurred, rather than 1945, the year in which the performance of the contract was completed.

1. Section 41 of the Internal Revenue Code, Appendix, *infra,* pp. 11-12, provides that net income shall be computed in accordance with the method of accounting regularly employed by the taxpayer in keeping his books, or if the method does not clearly reflect income, the computation shall be made in accordance with such method as,

in the opinion of the Commissioner, does clearly reflect income. Section 29.41-3 of Treasury Regulations 111, Appendix, *infra,* p. 12, recognizes that no uniform method of accounting can be prescribed for all taxpayers and that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. The fundamental requisite is that the method used clearly reflect income. That standard is not met when a taxpayer may freely give inconsistent treatment to an item for tax purposes when it suits him to deviate from his established accounting method.

The narrow holding of the Court of Appeals was that the expenditures made by the taxpayer's partnership in connection with the well which caved in in 1944 were deductible in 1945 and not in 1944. It is undisputed that the expenditures were made in the performance of a contract which was not completed until 1945. It is undisputed that the partnership, both in keeping its books and in reporting its income, treated each of its contracts separately, and did not report either the receipts therefrom or the direct charges in connection therewith until each contract was completed. It is thus seen that to permit the deduction of the items claimed in 1944, as the taxpayer contends, instead of in 1945, as the Court of Appeals has held, would be contrary to the taxpayer's own method of accounting and reporting.

Although general overhead expenses were not allocated to each contract, and hence were not deferred along with direct expenses, the partnership's method of accounting comes fairly within Section 41 of the Internal Revenue Code and Section 29.41-3 of Treasury Regulations 111. Appendix, *infra,* pp. 11-12. Its method was accepted by the Commissioner, the District Court, and the Court of Appeals. The Court of Appeals merely held that the direct expenses involved were incurred in connection with the completion of a contract, and should be deferred along with the other expenses so incurred.[1]

2. The taxpayer appears to complain (Pet. 12, 18) that the court below has converted a loss deduction under Section 23(e)(1) into an expense deduction under Section 23(a)(1)(A) in order to deny the deduction for 1944.[2] But there is not a word in the opinion below to support the sugges-

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[1] Section 29.42-4 of Treasury Regulations 111 (Appendix, *infra,* pp. 12-13) provides for the use of a "completed contract" method of accounting where certain "long-term" contracts covering a period of more than twelve months are involved. The method here used is not strictly within that Section since the contracts here involved were, for one thing, of shorter duration, but the system that was in fact used here has, as noted in the text, not been challenged, and would seem to be permissible under Section 29.41-3 of Regulations 111. *L.A. Wells Construction Co.* v. *Commissioner,* 46 B.T.A. 302, affirmed *per curiam,* 134 F. 2d 623 (C.A. 6th), certiorari denied, 319 U.S. 771.

[2] The pertinent portions of these sections are set out in the Appendix, *infra,* p. 11.

tion that the court below found such an approach necessary to its conclusion. Moreover, in the circumstances of this case, it would appear to be of no moment whether the deduction be deemed one for a loss or simply a business expense. For, no matter how denominated, the deduction involved is for expenses of labor and material utilized in digging the well which caved in. Those expenses are in all respects indistinguishable from the expenses involved in successfully digging a well, and taxpayer concedes that, on the partnership's method of accounting, such expenses would be deducted as of the date of completion of the contract. Even if the loss provisions of Section 23(e)(1) be invoked, it is clear that there was no loss in 1944, that the loss under the contract was not ascertained until 1945, when it was determined to be not $14,332.55 (which the taxpayer sought to deduct in 1944) but $631.44.[3] No loss, then, was sustained or realized by the partnership until the contract was completed in 1945.

3. As the district court noted (R. 28), the facts in this case were undisputed. The difference between the district court on the one hand, and the Commissioner and the Court of Appeals on the other, related only to the proper classification of

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[3] $631.44 is the difference between the total amounts expended and total amounts received under the contract as shown by the stipulation of the parties (R. 24-25).

the item here in question under the standard set by Section 41 of the Internal Revenue Code. Consequently, there is no real issue here concerning the power of the appellate court to set aside the trial court's findings of fact.[4]

4. The decisions cited by the taxpayer as being in conflict with the decision of the Court of Appeals in this case are inapposite, since in none of them was the court concerned with the treatment of an item of deduction consistently with an accounting practice which was "substantially the completed contract basis" (R. 100).

CONCLUSION

The court below correctly sustained the Commissioner's determination. There is no conflict of decisions, or other reason for further review.

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[4] Had the Court of Appeals found it necessary to set aside the findings of the trial court, it could properly have done so under the circumstances. *United States* v. *Gypsum Co.*, 333 U.S. 364; *Orvis* v. *Higgins*, 180 F. 2d 537 (C.A. 2d), certiorari denied, 340 U.S. 810.

Consequently, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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MAY 1952.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or business expenses.*—

(A) In general.—All the ordinary and necessary expenses incurred during the taxable year in carrying on any trade or business, * * *

* * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

* * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or

if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

(26 U.S.C. 1946 ed., Sec. 41.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.41-3. *Methods of Accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. * * *

* * *

SEC. 29.42.4. *Long Term Contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is

finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

* * *

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

* * *

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